Which is Best: Lump Sum or Pension Annuity?

by Eve Kaplan, Certified Financial Planner(TM)

Is a lump sum offer from an employer a better choice than a pension annuity for life? The former provides an immediate up-front amount (say $300,000), but the pension annuity gives you a stream of payments for life (example: $1,350 per month). A number of employers dangle a lump sum offer to employees in part to remove future liabilities from their balance sheets. It’s tempting for employees to select the lump sum as an obvious choice and forgo the pension stream. But is it the right choice? Like all decisions, the correct is “it depends.”

The right decision may come down to engaging a fee-only financial planner to consider the options within the context of your entire financial plan. Here are some things to consider:

1. Look at the whole picture. By plugging the 2 alternatives (and a range of projected investment return assumptions) into your financial plan, you can see the outcome if you and/or your spouse live to age 70, 80, 90 or 95 and beyond.

2. Your current and projected cash flow needs in retirement. How much of your net worth is locked up in e.g. your home, and how much is liquid? What percentage of your liquid investments and cash savings are tax-deferred? How much of your potential cash needs in retirement will come from pension-type annuities (such as defined benefit or cash balance pension plans from an employer, existing annuities and/or Social Security)?

3. A net present value (NPV) analysis. Using various interest rates, this analysis discounts future pension cash flows and generates a “net present value” that can be compared with a lump sum alternative. Like any analysis working with projected

variables (e.g. interest rates), various assumptions can tilt this analysis in favor of a lump sum or a pension annuity.

4. How long will you live? If you're married, how long will your spouse live? Unless you're terminally ill, no one can answer this so a good analysis will assume you may live into your 90s (and possibly beyond). Like Social Security, there often is a cross over point when it clearly makes sense to take a pension vs. a lump sum – e.g. if you/your spouse live past the age of 82. The biggest change to retirement – in recent decades – is the need to plan for longevity and the risk of outliving your assets.

5. How important is it to you to leave an inheritance?

6. What happens if I have a pension annuity and my employer defaults? Pension liabilities are governed by federal regulations; an employer cannot "wriggle out" of them. If your employer is purchased by another company, it still must honor pension obligations. In the unlikely event your employer goes bankrupt, the PBCG – a federal agency – takes up your pension obligation but it may pay out less.

7. How well protected are you from the ravages of inflation? A pension annuity typically does NOT inflate, but investing proceeds in a lump sum – and growing them effectively – can protect better against inflation over time. However, the onus is on your and/or your advisor to generate a decent return and none of us knows what the future holds for markets.

OK, it's clear there are pros and cons to lump sum vs. pension annuity choices but can you guess which option I tend to prefer for my clients?? The answer is: pension annuity for the majority of my clients – particularly variations of a 75% joint and survivor pension annuity if my client is married. This gives the surviving spouse 75% of the monthly benefit for the remainder of his/her life. Even if pensions don't inflate, the pension annuity may be a more secure and superior option to taking a lump sum.

My client base ranges from middle class to affluent and we work to balance various projected streams of income in retirement (including IRA Required Minimum Distributions) to cover future goals and unexpected contingencies. As always we work to minimize the very real risk of longevity.

A fiduciary (fee-only) financial planner will be able to determine the best choice for you, and disclose potential conflicts of interest. Even fee-only advisors like me DO have potential conflicts of interest. For example, one way fee-only advisors charge fees is to invoice clients on a percentage of the investment assets they manage. An advisor with a fiduciary obligation to put the needs of the client first will disclose potential conflicts of interest and he/she will lay out the analysis for a client.

In sum, “look before you leap.”